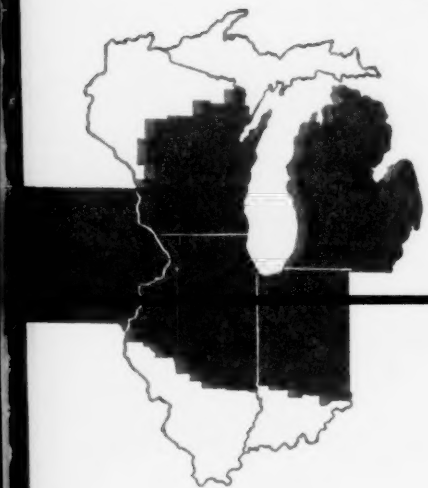
A review by the **Federal Reserve Bank of Chicago**

Business Conditions



1959 June

Contents

THE Trend OF BUSINESS

Business has continued to advance at an impressive pace in recent months. Total business sales and total industrial production passed previous record highs in February and March, respectively, and have since moved on to new high ground. Marked increases occurred during the spring in employment, retail trade and construction, and indications of future gains were suggested by the volume of new orders placed with manufacturers and awards of construction contracts. But the most significant recent development has been a substantial decline in unemployment, despite growth in the labor force.

Between March and April, unemployment dropped by over 700,000. Of course, warmer weather always brings a pickup in construction, agriculture and other out-of-door occupations. But only once before in the postwar period, in 1950, has there been a March-to-April decline in unemployment as large as the drop recorded this year. At 3.6 million, unemployment was 1.5 million less than a year earlier although still in excess of 5 per cent of the labor force.

Employment gains substantial

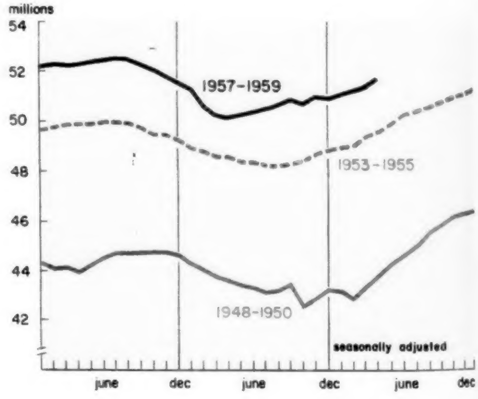
In April, the number of persons holding jobs of all kinds, including farm workers and the self-employed, reached 65 million. This was 2.1 million more than a year earlier and was a record for the month.

Nonfarm wage and salary employment, for which figures are available on a seasonally adjusted basis, has been rising each month since April of 1958. Seventy per cent of the reduction in wage and salary employment in the 1957-58 downswing had been regained by April of 1959.

Total employment does not change so abruptly as many other measures of activity. This fact is especially noticeable at the peaks and troughs of business fluctuations. Employment picks up most briskly only after the upturn has been under way for some time.

In 1948, 1953 and 1957, for example, there were plateaus in seasonally adjusted nonfarm wage and salary employment extending for six months or more over which this measure fluctuated less than one-half of 1 per cent. However, once employment had

Employment rise accelerated in the spring



Note: Data represent nonfarm wage and salary employment.

eased down appreciably from these "full-employment" plateaus, recovery to the previous record levels was not achieved quickly. In the 1948-50 period, it took about 20 months to reach a new high; in 1953-55, it took about 22 months. In April of 1959, 20 months had passed since the 1957 employment plateau. Although the previous high had not yet been regained, that goal would be achieved in another three months if employment were to increase as rapidly in the May-July period as it did in February, March and April.

Employment gains have been evident in nearly all Midwest centers. In May, new claims for unemployment compensation were only about half as large as in the year-earlier month. At the same time, lists of "shortage" occupations, mainly skilled factory and office workers, have been lengthening.

Retail buying vigorous

Because the date of Easter is not fixed, but shifts between March and April, comparisons of retail sales in these months with the year-earlier period can be confusing. One way of handling this problem is to combine the two months. In 1959, retail sales in March and April were at a seasonally adjusted annual rate of 215 billion dollars. This was a record level, up 10 per cent from a year earlier — the bottom of the recession — and 8 per cent above the same months in 1957. The sales gain reflected a greater willingness of consumers to spend as well as a 6 per cent higher level of personal income in the spring of 1959 than a year earlier. Automobile dealers and building materials dealers have reported increases of about 20 per cent, much larger than the total, but the rise has been quite general. Sales of food stores have been recording relatively modest gains.

Consumers have stepped up spending for the big-ticket durables and are using instalment credit much more freely. Dealers' stocks of appliances and furniture had been allowed to decline, with the result that factory sales of consumer durables recently have shown greater gains than retail outlets. Retailers have been rebuilding inventories and the large rise in new housing probably has boosted shipments to home builders.

Factory shipments of all types of major household appliances participated in the uptrend. During the first quarter, the number of washing machines shipped by producers, as reported by *Electrical Merchandising,* was up 17 per cent from 1958, dryers were 30 per cent higher, electric ranges 28 per cent, refrigerators 15 per cent, freezers 42 per cent and dishwashers 36 per cent. The dollar volume of furniture shipments was 12 per cent higher in the first quarter and new orders showed even larger gains.

A better auto year develops

Retail sales of domestically produced automobiles totaled 1.8 million in the first four months of 1959. This compares with only 1.4 million in the same months a year earlier. As a result of this sales trend, production schedules for May and June are holding close to the April level.

It now appears that the industry will produce almost 3.3 million passenger cars in the first half of 1959. This is a rise of more than 40 per cent over the same period of 1958. In the past six years, first-half auto production has averaged 54 per cent of the annual total and this proportion has been very stable. If the 54/46 ratio between the first and second half holds good in 1959, production would total about 6.1 million. This would about equal the total for 1957 and would fall appreciably short only of 1950 and 1955 output.

Financing the business upsurge

During the early months of 1959, business firms have enjoyed a comfortable financial posture. They have been able to increase their holdings of liquid assets while adding to inventories and receivables and making modest increases in expenditures on new plant and equipment. In 1958, the liquidity ratio for all corporations (cash and Governments to current liabilities) rose from 40 to 45 per cent for the first calendar-year gain since 1949. Corporate holdings of liquid assets, including cash, Governments and commercial paper, have continued to rise in 1959, in contrast with the early months of other recent years when these holdings have usually declined substantially.

The easier corporate financial situation is explained largely by four developments:

> a sharp rise in corporate profits and an associated increase in funds generated internally through undistributed earnings and depreciation charges;
>
> the policy of corporate managements, until recent months, to go slowly on new commitments for capital expenditures and other outlays;
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> the large volume of new security issues sold during 1957 and 1958; and
>
> the substantially lower payments on Federal corporation income taxes during the first half of 1959.

Will business firms continue to be able to finance rising activity without making substantially heavier demands on commercial banks and the capital markets? The answer, of course, depends on the pace and duration of the upswing and the future flow of funds from internal sources.

Business rolls its own

Discussions of business finance often concentrate on "external" sources of funds, mainly sales of securities and bank loans. These sources are extremely important, particularly in filling the residual requirements of business. Nevertheless, throughout the postwar period, funds generated by corporations in the course of their operations and retained in the business have far exceeded the amounts obtained from outside.

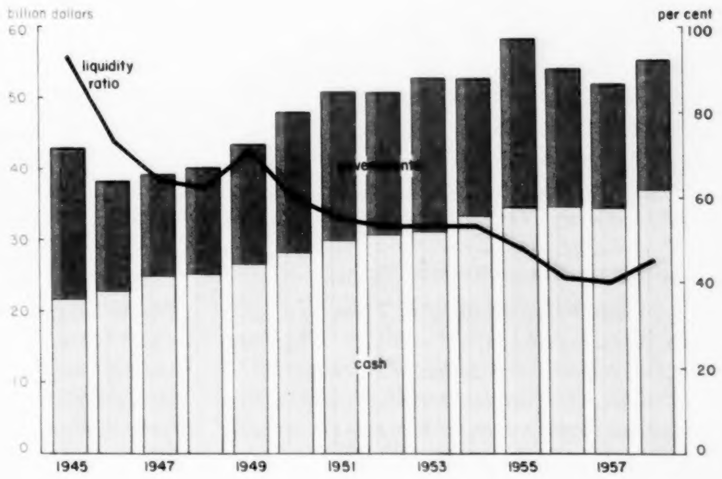
In the thirteen-year period, 1946-58, depreciation and retained earnings provided 259 billion dollars to business corporations. This compares with 113 billion added by the net increase in bank loans and security issues —a ratio of 7 to 3.

This proportion has not varied greatly during the period except that in the three recession years—1949, 1954 and 1958—the proportion of internally generated funds was larger, mainly because bank loans in the aggregate were reduced somewhat. In 1952 and 1953, the proportion was lower because of a drop in undistributed earnings, partly reflecting the impact of the excess profits tax.

The depreciation saga

In recent years, funds retained from operating revenues through depreciation, a noncash expense, have come to dominate the

Corporate liquidity improved last year for the first time since 1949



volume of funds provided by internal sources. In the years immediately after World War II, depreciation was relatively small because a large proportion of the depreciable assets on the books of business firms had been purchased at prewar prices, and those facilities which had been built in wartime with private funds were commonly written off rapidly under special regulations.

Since World War II, the growth in depreciation has been steady and has averaged over 1 billion dollars per year. This is mainly because of the increase in the book value of depreciable assets which has resulted from heavy expenditures on new plant and equipment throughout the postwar period. In addition, accelerated depreciation on defense-related projects since 1950 and the more rapid write-offs permitted under the Revenue Act of 1954 have helped to swell such charges.

In 1952, depreciation exceeded undistributed earnings for the first time, and it has been the larger of the two in each succeeding year. Moreover, the gap has tended to widen, particularly in recession years when profits have declined. In 1959, depreciation charges will exceed 23 billion dollars for all corporations. This compares with only 5 billion dollars twelve years earlier. The tremendous importance of depreciation in the business financial picture is indicated by the fact that even if undistributed earnings were to rise during 1959 to the record 1950 figure of 13 billion dollars, depreciation would still exceed that amount by about 80 per cent. In 1950, the opposite relationship prevailed.

The profit high jump

With corporate tax rates unchanged for the past five years, and with dividends and depreciation showing a gradual uptrend, undistributed earnings have been the residual, volatile portion of the internally generated funds. In 1958, retained earnings fell to 5.7 billion dollars, the lowest in the postwar period. Even this total was reached only because of a strong rise in the fourth quarter.

In the January-March period of 1958, the annual rate of retained earnings was only 3 billion dollars. In the comparable period of 1959, the figure was about 3½ times as large. Before dividends, corporate profits were about 50 per cent larger than in the same period of 1958, according to a num-

ber of private surveys. For the year as a whole, profit gains probably will be much less than this because of the sharp increase toward the end of 1958. Nevertheless, it is widely anticipated that corporate profits will be at a new record for 1959 as a whole. Some financial writers project a total of over 50 billion dollars before taxes. If these predictions prove to be correct, and there is no large change in dividends, undistributed profits would be in the 12-13 billion dollar range.

Lengthening corporate debts

The relatively comfortable financial position of corporations in recent months has resulted in part from decisions made in 1957 and 1958. In those years, a large volume of security issues was floated despite a substantial slide-off in financial requirements.

In 1956, corporations utilized 46.0 billion dollars for capital expenditures and additions to inventories and customer receivables —a record amount. Outlays for these purposes dropped to 38 billion in 1957 and to less than 25 billion last year. However, instead of declining with financial needs, net issues of securities amounted to 8, 11 and 10 billion, respectively, in the years 1956, 1957 and 1958.

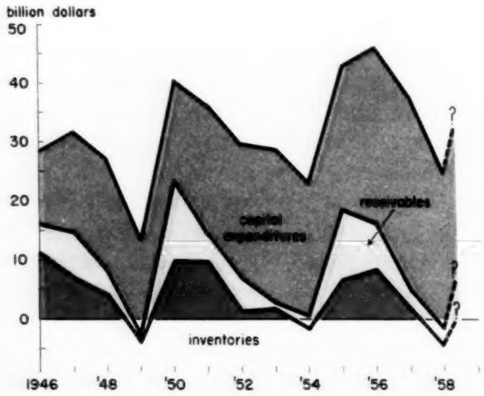
The fact that capital issues were large last year in the face of reduced needs for funds permitted many corporations to reduce short-term debt. In addition, it helps explain why net security issues in the first five months of 1959 were almost one-third less than during the same period in 1958.

Liquidity and the Mills Plan

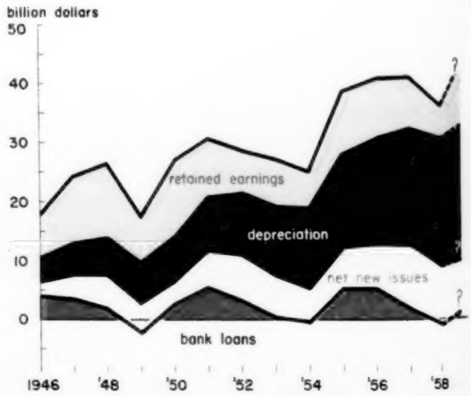
In the first quarter of 1959, business corporations paid out 6.2 billion dollars in income taxes. This was 1.2 billion dollars less than in the previous year and was the smallest amount since 1951. In large part, the reduction was the result of lower profits in 1958, but it also reflected the operation of the first and second Mills Plans for accelerated payment of corporate income taxes.

Prior to 1951, corporations paid the tax liability incurred in a given year in four equal quarterly instalments in the following year. The Revenue Acts of 1950 and 1954 required a speed-up of these payments.

Principal uses of funds



Principal sources of funds



Next year, the second Mills Plan will be complete, and corporations will be paying 50 per cent of their 1959 tax liability in the first half of 1960 and 50 per cent of the 1960 liability in the second half of 1960. However, in 1959, the transition is still in process. Corporations are paying 60 per cent of their 1958 tax liability in the first half of 1959. In the second half, they will be on a current basis, obligated to pay 50 per cent of the much larger 1959 tax bill.

Speeding up payments has had the effect of reducing the average tax liability owed by corporations at any given time. Under the method of tax payment prevailing before 1951, a corporation's tax liability on the books averaged somewhat more than the

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Bank liquidity and rising business

As the upward sweep of activity pushes the economy to record levels of production and income, a question arises as to whether banks are in a position to supply large additional amounts of credit as during the earlier postwar upturns.

In August 1954, for example, at the low point of the post-Korea recession, member banks of the Federal Reserve System held nearly equal amounts of loans and Government securities: each totaled about 56 billion dollars. In August 1957, after three years of vigorous economic expansion, member bank loans had risen to more than 80 billion dollars while their holdings of Governments had been reduced to about 45 billion. This switch from Governments to loans followed a pattern more or less characteristic of postwar economic upswings.

Funds to sustain expansion

Increasing output, of course, requires additions to inventory and payrolls. As sales build up, receivables also grow, and tax liabilities rise along with profits. All combine to boost working capital requirements. Many firms, in addition, increase plant and equipment expenditures to pave the way for still further expansion of output, thus requiring additional investment capital.

While business thrives, consumers step up their spending for durables, and many investors, both individual and institutional, add to their holdings of financial claims. Businessmen, consumers and investors, therefore, need money to support higher levels of economic activity. During each postwar expansion, many have turned to banks to supply additional funds.

A new pattern of expansion?

Of course, no two cycles of recession and expansion are exactly alike. In particular, the recovery which began about a year ago has not until recently sparked the kind of increase in bank loans associated with earlier postwar upturns.

An increase in deposits would enable banks to accommodate the stepped-up loan demand. Alternatively, banks might sell securities to provide funds for lending. A rise in deposits, however, is closely tied to Federal Reserve monetary policy — a policy which in turn responds to those monetary

needs consistent with maximum growth at stable prices. The market in which banks sell securities is also conditioned by Federal Reserve policy, but here investment policies of individual banks play a more active role. Thus, the extent to which banks can match their earlier performance in accommodating loan demands hinges in part on their reserves of securities—or, more generally, their overall liquidity position.

Bank liquidity—active and passive

The liquidity position is, of course, a focal point of bank operations. In its day-to-day operations, a bank continually receives funds from a variety of sources: deposit inflows, loan repayments, interest and amortization receipts, and sales or redemption of securities. And bank funds are paid out to cover operating expenses, deposit withdrawals, loans disbursed and securities purchased.

Thus, like other businesses, a bank needs a pool of liquid assets to serve first as temporary storage for net inflows of funds—until they can be put to work in more permanent investments; and second as a buffer between commitments and any unpredictable net outflows.

As an investor, a bank also has a more positive use for liquid assets, namely, as a reserve to be drawn upon when favorable investment opportunities arise. This function may be of paramount importance in the longer-run or "strategic" management of bank liquidity.

Since the liquidity pool accommodates operating needs while playing a role in investment strategy, it serves both "passive" and "active" functions. Management of the liquid reserves is thus a kind of balancing process involving continual judgment of the prospective inflows and outflows and always with an eye toward future investments.

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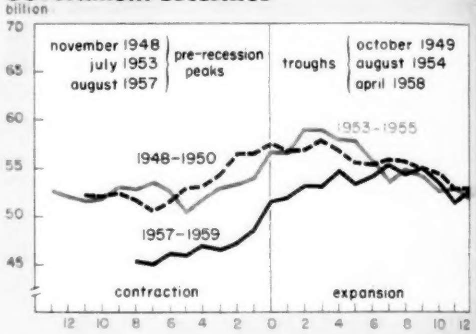
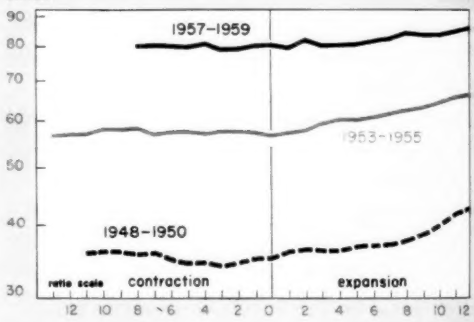
Bank Liquidity in Perspective

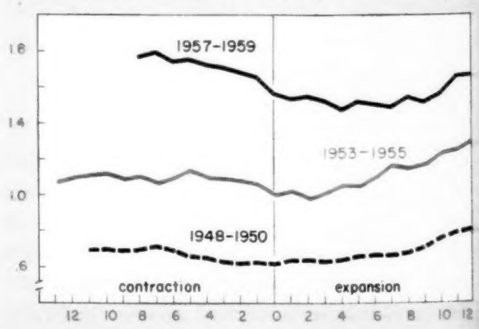
Government securities



Total loans



Ratio: total loans to Governments



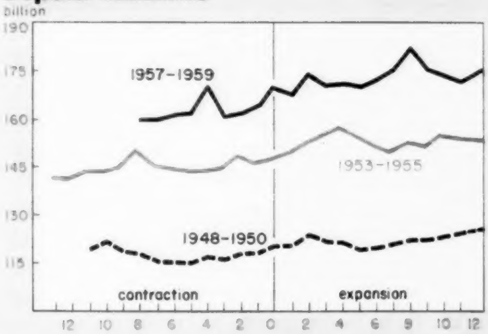
patterns of recession and recovery

Government securities. Bank holdings of Governments have traced roughly similar patterns during postwar recession-recovery periods. As loan demands lag during downturns and reserve pressures are eased, banks add to their Government portfolios—then work off the addition when loan demand picks up with improving business. During the most recent upturn, however, a slower-than-usual pickup in demand for **loans** accompanied cash deficits of the Treasury. The **ratio of loans to Governments,** therefore, has not shown nearly the customary increase in the latest recovery period . . . while **gross deposit liabilities** have followed their usual cyclical pattern—in augmented fashion—supplying banks with substantial funds for lending and investing.

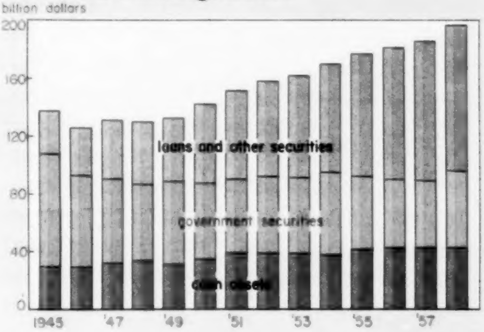
Cash and earning assets. Over the postwar period as a whole the aggregate cash and earning assets of member banks have followed the upward course of the American economy . . . while changing **asset structure** has reflected banks' accommodation of varying financial needs. The relative expansion of "loans and other securities," in particular, mirrors the demands of a predominantly peacetime economy. One result, however, has been a relative decline in Government securities—banks' most effective reserve of liquid funds—from the high levels at the end of World War II.

Total deposits. Deposit liabilities over the same interval have increased sharply . . . while **deposit structure** has changed notably. The growth in savings-type deposits has shown an especially uniform increase since the war. The relatively slow turnover of such deposits, together with their tendency to rise during business downturns, suggests that their proportionate growth has had a favorable effect on bank liquidity positions.

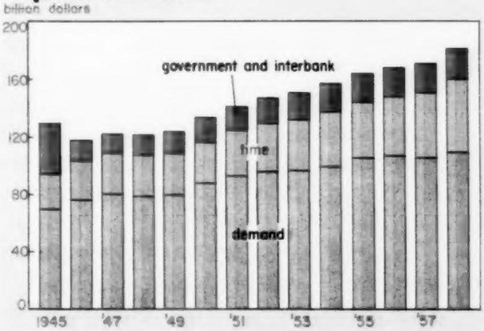
Deposit liabilities



Cash and earning assets



Deposit liabilities



The task of management, however, is complicated by the fact that liquidity and profit usually do not go hand in hand. While liquid assets permit making opportune investments and protect such investments from untimely sale, liquidity, beyond a certain point, is purchased at the price of earnings. The yield and liquidity of individual assets generally vary in opposite directions.

What does it mean to classify an asset as more or less liquid? Clearly, the term conveys the idea of "nearness to money." Cash itself is in fact "perfectly liquid"—that is, immediately acceptable in exchange for other assets at a market price of "one hundred cents to the dollar." Thus, all assets can be ranked by liquidity according to their greater or lesser resemblance to cash.

For some assets, the similarity is extremely close; Treasury bills are a case in point. As direct obligations of the United States Government maturing in less than one year, mostly within three months, these bills are about as close to currency or demand deposits as any noncash asset. And three characteristics contribute notably to their "moneyness": short maturity, ready salability and superlative credit rating. Investors, therefore, often use these criteria to rank all assets in terms of liquidity.

The tools of liquidity management, however, are not quite the same for banks as for other business concerns. For one thing, money is a bank's stock in trade. But earning assets have in recent years provided more than 80 per cent of banks' operating income. The ever-present incentive is therefore to hold cash assets near the minimum levels required for day-to-day operations, while keeping "effective" liquid reserves in near-monies — such as short-term Government securities.

After about a year of sustained expansion, how well do the liquid reserves of banks measure up against those held at comparable stages of earlier postwar expansions? More specifically, how do these liquid assets look in view of past and prospective flows of deposits and loan-funds?

Where do we stand?

Since business upturns are not alike in their finer details, picking a "comparable stage" in earlier expansions is somewhat arbitrary. But taking the widely used dates provided by the National Bureau of Economic Research, here is the comparative picture:

Government securities. During the year following the trough of the most recent recession — April 1958 through April 1959 — member banks added roughly a billion dollars in Governments to their portfolios, bringing the total up to about 52.5 billion. This increase contrasts sharply with declines of about 5 billion at the comparable dates of earlier recovery years — October 1950 and August 1955.

Moreover, bank-held Governments maturing in five years or less — those toward the more liquid end of the asset spectrum — made up about 75 per cent of the Government portfolio in January 1959, in contrast to only 52 per cent at the comparable date in 1955. (The 1950 figure for member bank Governments maturing in five years or less was 81 per cent but is not comparable because of the bond support program then in effect.)

Loans. Total member bank loans, as noted, have so far failed to score their usual post-recession advance and by the end of last April were only about 6 billion more than twelve months earlier. The two previous recoveries produced dollar increases of about 7 and 10 billion dollars, respectively. But

the percentage increases show much sharper contrasts: 1950, up 21 per cent; 1954, up 17 per cent; and 1959, up only 8 per cent.

Deposits. The gross deposits of member banks expanded at comparable rates during all three recovery years — about 4 per cent. The recession patterns, however, show marked contrast. From pre-recession peak to trough, deposits rose 1 per cent in 1949, 4 per cent in 1954 and 6 per cent in the 1958 period.

Appraisal—

Thus, member bank holdings of Governments, potentially capable of supplying funds for loans, are as large in dollar amount as after the initial year of earlier postwar recoveries. But liquidity is at least partly a matter of comparisons, and one ratio of special significance is that of loans to Government securities. This ratio at the end of April 1959 was 1.7, more than twice as high as the 0.8 recorded for the comparable date in 1950 and also markedly higher than the 1.3 of 1955. The decline in Governments relative to loans has led some observers to conclude that banks may be reluctant to expand loans at the expense of Governments — at least to the same extent as in earlier periods of rising business activity. The uptrend in the ratio of loans to Government securities, however, reflects one of the most stable features of bank asset behavior since the war (see charts, pp. 8-9). Moreover, the larger proportion of short-term Governments in bank portfolios suggests that banks have prepared to meet the expected loan demand. (Their shorter maturities are, of course, less subject to price decline if interest rates move up according to the usual recovery pattern. Thus, they can be sold at little or no capital loss to provide funds for loans.)

Still, banks cannot be expected to pare down their Government portfolios indefinitely in response to expanding loan demands. The growth in total loans during the entire 1954-57 upturn was roughly 24 billion dollars. The decline in holdings of Governments "accounted for" only about 11 billion of this increase; therefore, a large part of the loan expansion had its origin in rising deposits (see charts), which, as usual, were the major source of bank funds. But such deposit growth, as mentioned earlier, depends greatly on Federal Reserve policy.

—and reappraisal

Past experience may also be putting bank liquidity requirements into a new perspective. Judgments, no doubt, have been conditioned by the strength of the longer-term economic uptrend and the brevity of postwar recessions. The liquid assets of the banking system are now being used more and more as a reserve of uncommitted funds with which to meet cyclical demand for loans. Furthermore, the growth in gross deposits experienced in every postwar recession (especially marked in the most recent one) suggests that the liquid reserves required to meet deposit drains may be quite small in the aggregate. For this reason, individual banks may feel capable of working off a portion of their Government portfolio in coming months if expected loan demands materialize. Prudent management, however, will limit any reduction in Governments to modest amounts. As custodians of the greater part of our money supply, individual banks must maintain liquidity positions to accommodate the "unexpected" as well as "expected" demands. Nevertheless, the banking system, operating within a framework of flexible monetary policy, is in a position to provide any volume of credit consistent with maximum growth at stable prices.

Banks have favorable experience with consumer loans

At the onset of the 1957-58 recession, Seventh District member banks held nearly 2.3 billion dollars in consumer loans. This was roughly one-fifth of their total loan portfolio. Although employment and personal income showed substantial declines in Midwest industrial centers during the recent recession, District banks had only small write-offs of consumer loans. This generally favorable experience is reflected in the continued efforts of many banks to expand their loan service to consumers.

Gross charge-offs of consumer loans at District member banks in 1957 amounted to 5.7 million dollars, or roughly one-fourth of 1 per cent of the average amount of such loans outstanding. During 1958, gross charge-offs were somewhat higher, slightly more than one-third of 1 per cent of outstandings. However, after allowance for recoveries on loans previously charged off, net charge-offs during each of the two years ran less than *two-tenths* of 1 per cent, or under $200 per $100,000 of loans outstanding. Such published data as are available indicate that these rates are exceedingly low for this type of lending, although somewhat higher than charge-offs by District banks on other types of loans. These conclusions are based upon data for 1957 and 1958 collected in surveys of Seventh District member banks.

Wherever possible *net* rather than *gross* losses have been used in comparisons because gross figures are affected by bank policy with respect to write-offs. Since the number of consumer loans in many banks is very large, a rather mechanical procedure for making charge-offs is used, based upon historical delinquency rates of specific types of loans. Moreover, policy in some banks will result in high gross charge-offs and high recoveries; in other banks, low gross charge-offs and low recoveries will occur. The result may be approximately the same rate of *net* charge-offs.

Large stake in consumer credit

Although banks entered the consumer lending field somewhat later than their major competitors, they now hold about 35 per cent of total consumer loans. Their holdings of *instalment* loans exceed those of sales finance companies, consumer finance companies or credit unions and are more than 2½ times the instalment debt held by retail establishments. In *noninstalment* credit, their volume of single-payment loans to individuals is second only to charge accounts at retail stores. In addition, banks extend large amounts of credit to sales finance companies, retail merchants and other firms which in turn extend credit to consumers.

The growth of consumer lending has re-

A summary of District member bank loss experience on business, real estate, farm and other types of loans, as well as consumer loans, during 1957 and 1958 is available upon request to the Research Department, Federal Reserve Bank of Chicago.

sulted in part from a rise in the number of banks which make personal loans (see chart). Also, banks have offered an increasing variety of loan services. Most banks today buy dealer paper as well as make loans direct to individuals. A recent innovation at some banks is a personal credit plan which in some respects resembles revolving credit arrangements at department stores.

The 1957-58 experience . . . in loan volume

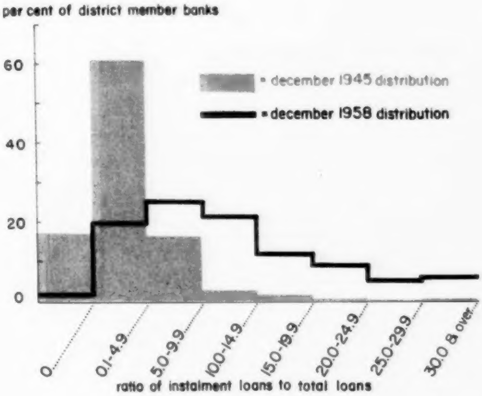
The impact of the 1957-58 business downturn on the total volume of consumer loans outstanding at District member banks differed from that in the two previous recessions. Largely because of a decline in holdings of automobile and other retail instalment paper, consumer loans in June and September 1958 were 3 and 6 per cent, respectively, below year-earlier figures. During the 1949 and the 1953-54 downturns, however, outstanding loans exceeded the year-earlier figures on each of the quarterly dates for which information is available.

The difference in credit trends in these periods reflected largely the different patterns of consumer buying. Purchases of automobiles and other big-ticket consumer items were cut back quite sharply during late 1957 and early 1958. Concurrently, the demand for consumer loans declined. Expenditures for nondurables also declined in the fourth quarter of 1957, but less sharply. During the two previous recessions, consumer buying was maintained relatively well.

. . . and loan charge-offs

As indicated above, Midwest banks in the aggregate showed small charge-offs, gross as well as net, relative to their total holdings of consumer loans in 1957 and 1958. Comparison with experience of other lenders is

More banks in instalment loans in a bigger way



handicapped by a paucity of comparable information. However, published reports of small loan companies and credit unions in several of the Seventh District states showed net write-offs during 1957 and 1958 in the range of one-half of 1 per cent to nearly 2 per cent. This compares with less than two-tenths of 1 per cent for District member banks.

Variations in individual bank charge-offs were substantial. Roughly 45 per cent of the District banks had either zero net charge-offs or net recoveries on consumer loans during 1957. In 1958, this percentage fell to 35. For the entire group of about 1,000 banks, the range was from net charge-offs of 10 per cent to net recoveries amounting to 12 per cent of average outstandings.

The loss data from the 1957 and 1958 District bank surveys have certain limitations which should be noted. For example, the data do not reveal to what extent recourse arrangements may keep defaulted loans from showing up on banks' books. If a default occurs on a contract purchased from an auto-

mobile dealer under a full recourse agreement, the dealer is obliged to pay the bank the balance due. Under this arrangement, the defaulted loan does not appear as a charge-off on the bank's books. The extent to which similar arrangements minimize charge-offs of consumer loans by other lenders is not known. Furthermore, since these data cover only two years, the relationship between gross and net charge-offs cannot be gauged precisely. Finally, because of the way bank records are kept, the data reported in these surveys include some instalment loans to individuals for business purposes.

. . . by size of bank

Net charge-offs varied inversely with size of bank. Losses per $100,000 of outstanding consumer loans in 1958 ranged from $166 for the largest banks (those with total deposits of 100 million dollars or more) to $215 for the smallest banks (those with deposits of less than 10 million dollars). A distribution of individual bank charge-offs, however, showed a pattern which in some respects was considerably different from that indicated by this over-all relationship. The higher rate for the small banks was due to relatively high charge-offs by a few of these banks; a large proportion showed no charge-offs at all.

. . . by degree of specialization

The data also showed a direct relationship between the importance of consumer loans in banks' total loans and the rate of charge-offs. For example, only 17 per cent of the banks in which 30 per cent or more of total loans are consumer loans had zero net losses or net recoveries. On the other hand, 53 per cent of the banks with less than 10 per cent of their portfolios in consumer loans had such net loss experience.

The fact that consumer loan charge-offs increase with the ratio of consumer to total loans may indicate that as a bank moves aggressively to expand holdings of consumer loans it includes more loans which previously would have been considered marginal. Consequently, charge-offs rise, up to a point.

If account is taken of both size of bank *and* proportion of consumer loans, as is done in the accompanying chart, losses are most common in the largest banks with the greatest concentration (bottom right); they are least common in the smallest banks with the least concentration (top left). However, in the largest banks there were no losses in excess of 1 per cent, whereas in the smallest and medium-sized banks losses of over 1 per cent were found in 5 to 10 per cent of the bank classes indicated.

. . . and by region

Since the 1957-58 recession had a very uneven impact upon the various regions within the Seventh Federal Reserve District, geographical location of bank was investigated as a possible factor explaining differences in consumer loan charge-offs. However, when banks were classified by state as well as size of total deposits, no significant difference in charge-offs appeared for the two largest size groups. But, among the smallest deposit-size group (banks with deposits of less than 10-million dollars), there were some significant differences. Michigan and Iowa represent District extremes with respect to severity of the 1957-58 downturn in business activity. It is interesting to note, therefore, that the proportion of small banks showing losses was nearly twice as large in Michigan as in Iowa.

Further questions

Other factors may have important effects

on net losses on consumer loans—for example, aggressiveness of lending policy and quality and experience of management. Such factors have not been evaluated as to do so would require a qualitative judgment of operating policies and practices beyond the scope of a purely statistical treament.

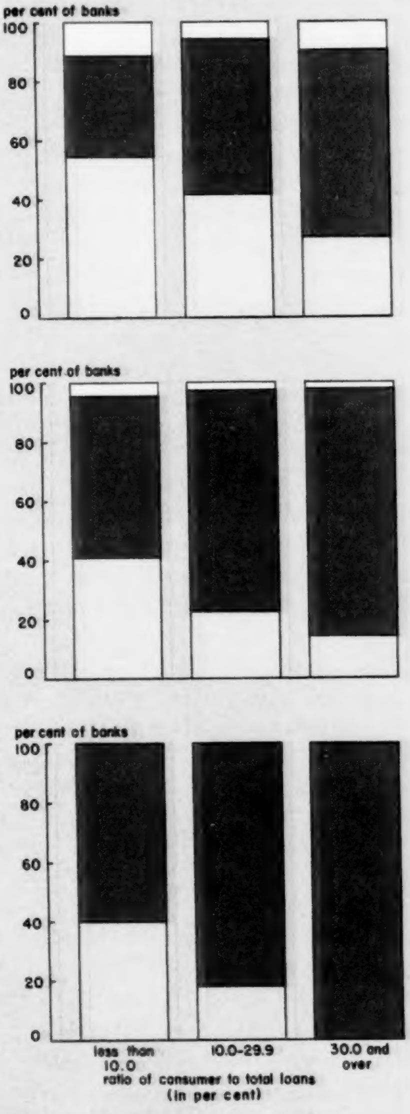
Differences in loss ratios are not necessarily indicative of the quality of management or the profitability of consumer loans at individual banks. While comments of credit men in commercial banks indicate that a net annual write-off of less than 1 per cent of consumer loans outstanding represents a satisfactory performance, it does not follow that a total absence of loan losses is a practical goal for every consumer loan department. Too rigid screening of loans, in addition to being costly, may have the effect of turning away business which in the aggregate would be highly profitable.

Pattern of consumer loan losses in 1958

Among the smallest banks, net charge-offs of 1 per cent or more, as well as zero charge-offs and net recoveries, occurred most frequently in banks having relatively small holdings of consumer loans . . .

. . . and this was true also for the medium-sized banks

. . . while at the largest banks, there were no net losses as high as 1 per cent



charge-offs: zero, less than 1 per cent, and 1 per cent and over of outstanding consumer loans.

Upsurge—*continued from page 7*

liability incurred during a year because of lags in payments. Under the present system, the amount will be only half as great as formerly. The effect is already becoming apparent.

This speed-up in tax payments will reduce the contribution of a rising tax liability to financing business needs in future periods when business activity and profits rise sharply. In 1950, before the acceleration in corporate tax payments, rising business activity and corporate profits increased substantially. Because taxes accrued in 1950 were not payable until 1951, the outstanding corporate tax liability rose by 7 billion dollars during the earlier year. This rise in the tax liability in 1950 exceeded the amount of funds obtained through bank loans and security issues combined. To the extent that profits were retained to meet the tax obligation, these funds could have been used temporarily in financing business needs. Some firms, of course, "fund" their tax liability through the purchase of interest-bearing liquid assets.

The fact that the tax liability will be less important as a source of funds may become apparent in the second half of 1959. In 1958, payments in the second half were only 44 per cent as large as in the first half, and in preceding years tax payments in the second half were relatively much smaller.

The course of liquidity

Liquidity of business firms always tends to improve in the aggregate during recessions. Some firms, of course, become "strapped" and find that cash inflow slows down faster than outgo. But aside from this, cash outlays drop faster than inflow and liquidity improves even though profits decline.

When sales are falling, there is a tendency to hold back on new capital expenditures and to introduce measures of various kinds which cut costs and reduce cash outlays. At the same time, efforts to reduce inventories and receivables help to boost cash.

This tendency for business firms to become more liquid continues, indeed it may accelerate, in the early stages of business revival. This is partly because inventories continue to decline as sales rise faster than production, and because collections of receivables usually speed up. But most important is the sharp increase in profits which ordinarily accompanies such a development. (These factors have been particularly important in early 1959.) As expansion continues, financial requirements are boosted sharply as a result of increased inventory, receivables and capital expenditures, and the liquidity position declines.

In the spring, it appeared that the cash flow from depreciation and undistributed earnings during 1959 would be sufficient to support a further rise of business activity without heavy resort to outside sources of funds. However, it is conceivable that capital expenditures will rise much faster than surveys of business plans have indicated, and, for the year as a whole, inventories and receivables could grow at a rate in excess of that of the first quarter.

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